

Section Three

Stops

Managing Risk Is the Key to Trading

This Means That Exits Are An Important Element

There Are Three Ways To Exit

1. Reversals
2. “Danger” Signs Based on Signals (Momentum)
3. Stops (Covered in this Section)

In Our Evaluation Of How Much We Are Risking We Focus On Stops

How Much Am I Risking Per Trade?

Use Of Existing Stop Methods

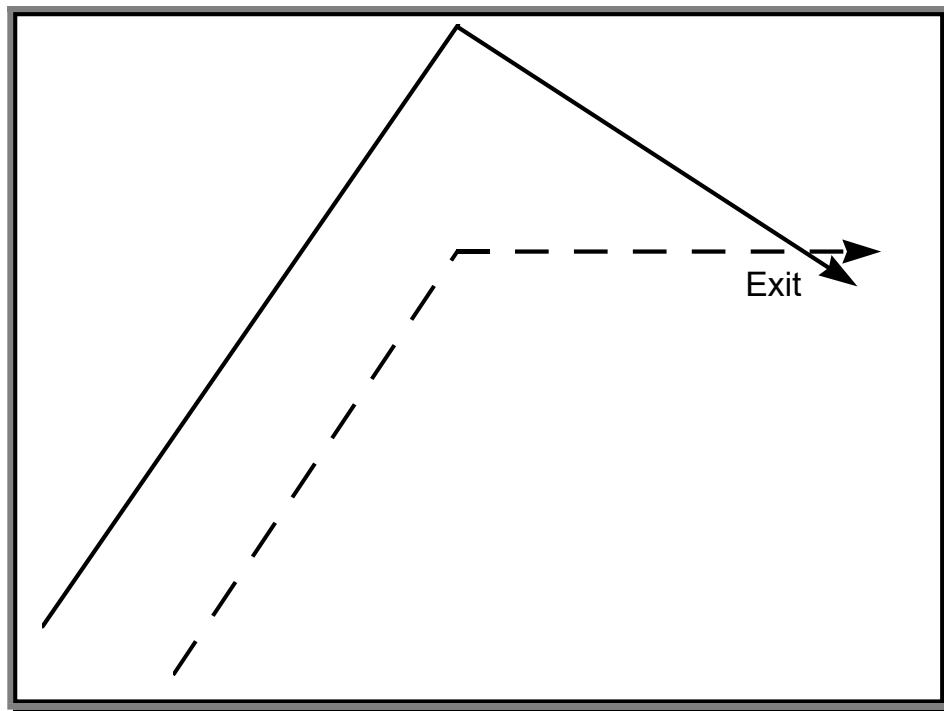
We Can Classify Stops Two Ways

1. Are the Stops Subjective or Objective?
2. Can the Stop be Approximated Ahead of Time?
3. The “Ideal” Stop, Is It Both Objective and Calculable?

Many Traders Are Taught To Use “Subjective”, Calculable Stops

- How Much I Can Afford?
- Do I Want to Break-even?
- Fixed Value from Entry (Based on Comfort Level)
- Fixed Value Trailing Stop (Based on Comfort Level)

Chart 3.1 - Fixed Value, Trailing Stop



Even if you buy at the **low tick** and sell at the **high tick**, the amount “won” is limited by the size of the move.

Most traders set stops based on the amount per unit they feel comfortable with, or based on what they can afford.

Guess what? The market does not care what you are comfortable with or how much you can afford.

Setting stops subjectively can lead to....

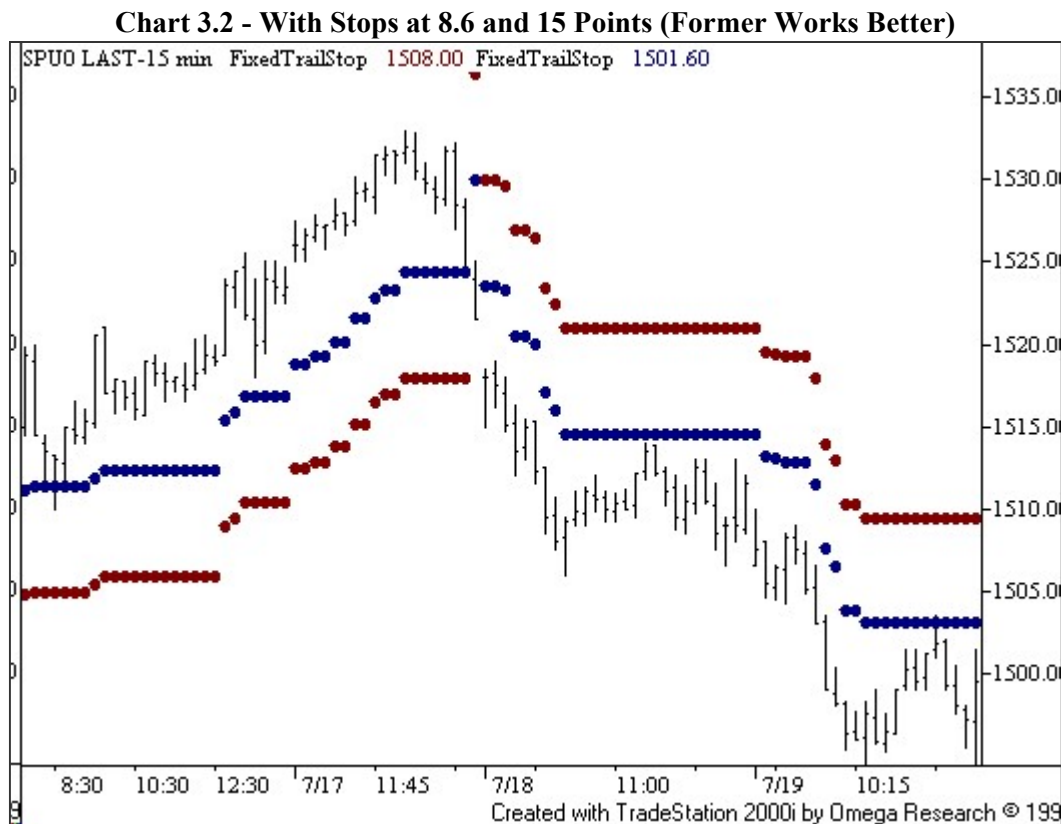
- Exiting too soon
- Holding losses too long

Assume two investors are trading the S&P500 Index. Let's say the investors are only willing to lose a maximum of \$15,000 per trade. Contract unit = 250* price of contract.

Investor One wants to trade four contracts, so he can take $\$15,000/4 = \$3,750$ risk per contract, or $3750/250 = 15$ points, shown as dark red dots, furthest from the price action.

Investor Two wants to risk no more than \$2,150 per contract, so he sets his stops at $\$2,150/250 = 8.6$ points and he can trade $\$15,000/2,150 = 7$ contracts, shown as dark blue dots, closest to price action, below.

By inspection, we can see that Investor Two has made a better choice.



Objective Stops Which Cannot Be Easily Calculated In Advance, But Which Make Logical Sense, Include Profit Taking Stops, Stops Based On Forecasted Price Points, And Breakout Stops.....

Chart 3.3 - Breakout Stop on Coffee, CFK01

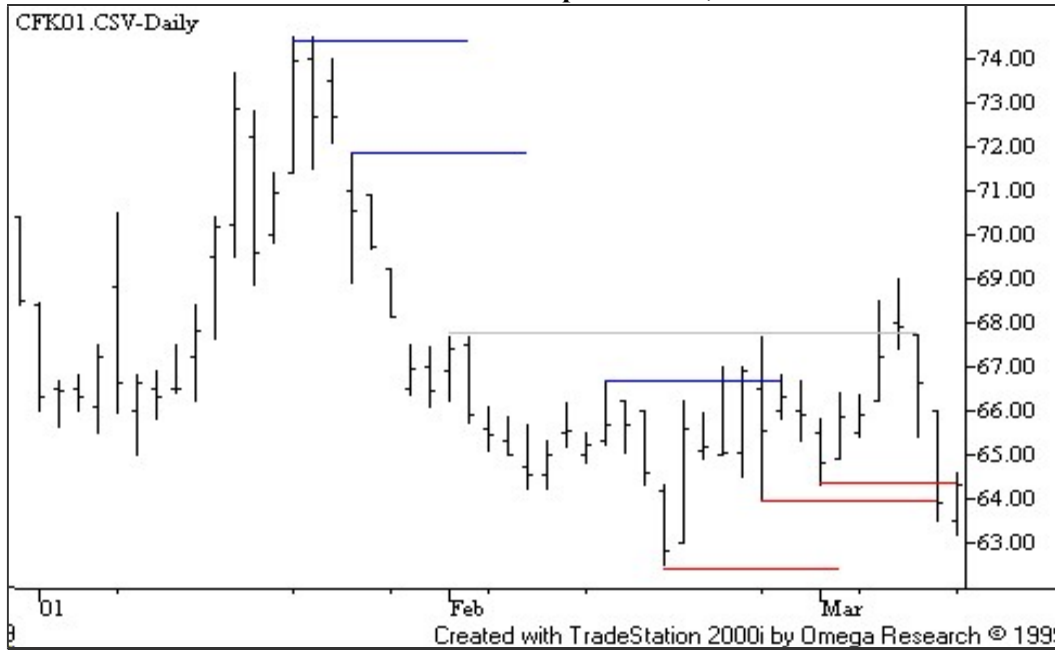


Chart 3.4 – Eurodollar, EDM01 with Breakout Stops



One Issue on Breakout Stops is Where to Determine Swing lows or highs. This depends on the level of sensitivity of the “swings”.

Chart 3.5 - Breakout Stops on Brent, QOJ01 with Level “2” Swings

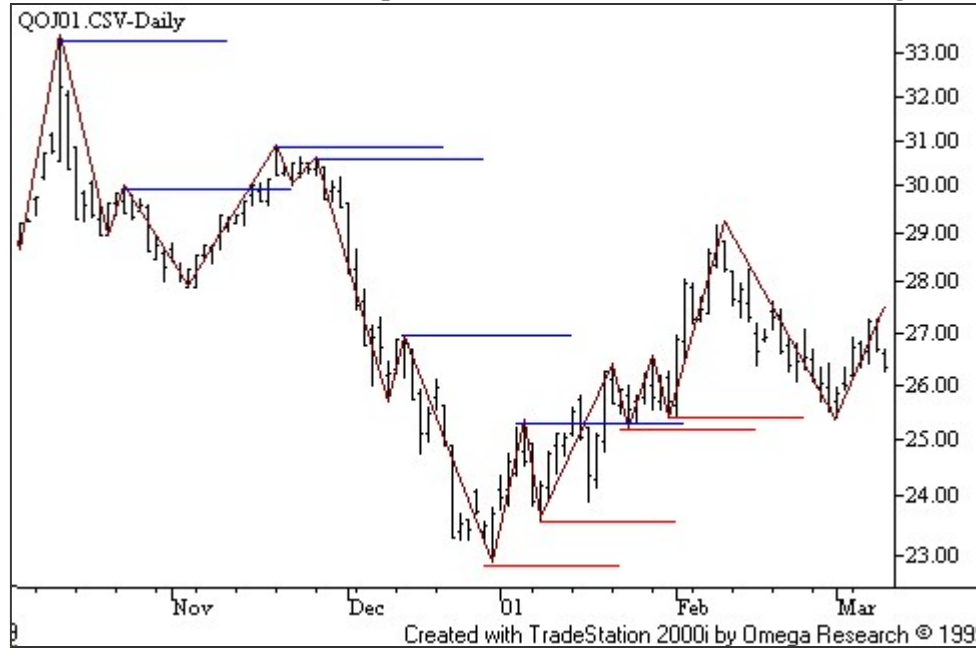
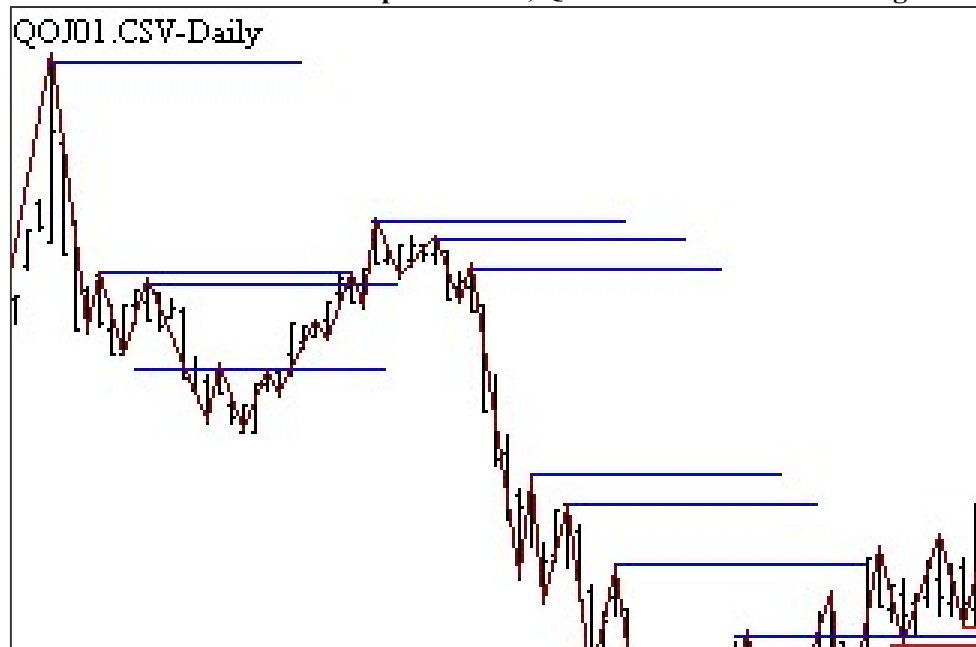


Chart 3.6 - Breakout Stops on Brent, QOJ01 with Level “1” Swings



Inactivity Stops

Rule of thumb – if there is no gain in the trade for

3 to 5 days on a daily chart

5 to 8 bars on an intraday chart

Exit – or begin to exit and pull in stops

Chart 3.7 - Inactivity Exit, GCJ01, February 27, 2001

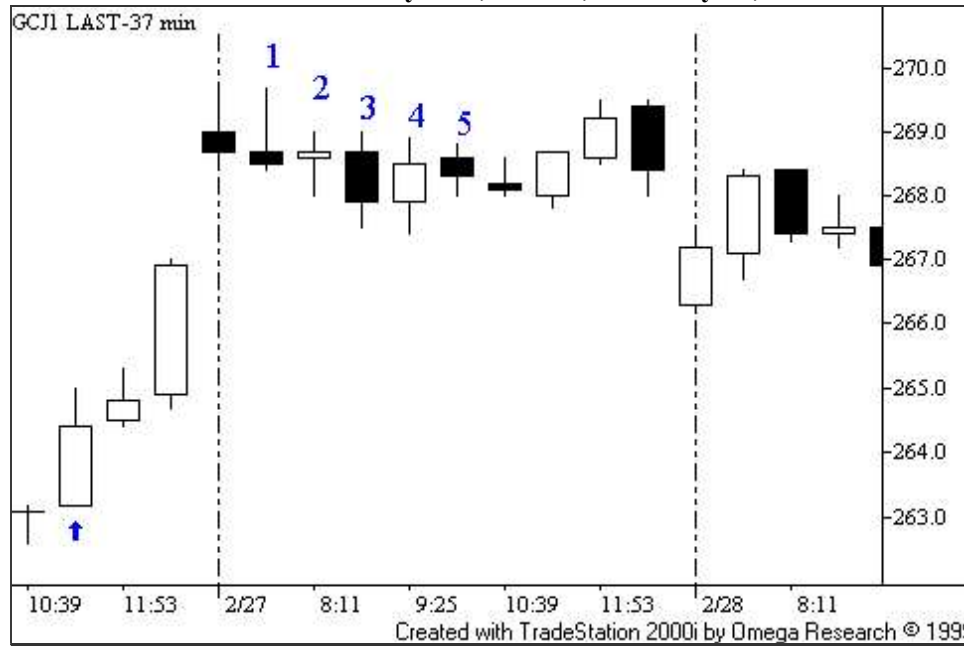
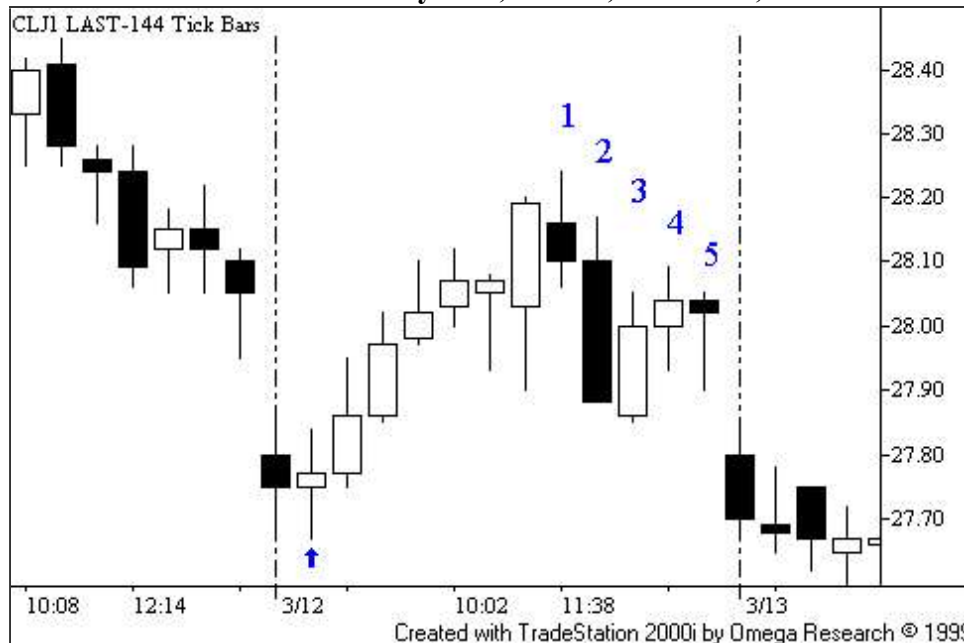


Chart 3.8 - Inactivity Exit, CLJ01, March 12, 2001



The Parabolic (Time/Price System)

If long, the parabolic starts with the stop at the low of the “turn”. If short, it starts off with the high of the “turn”.

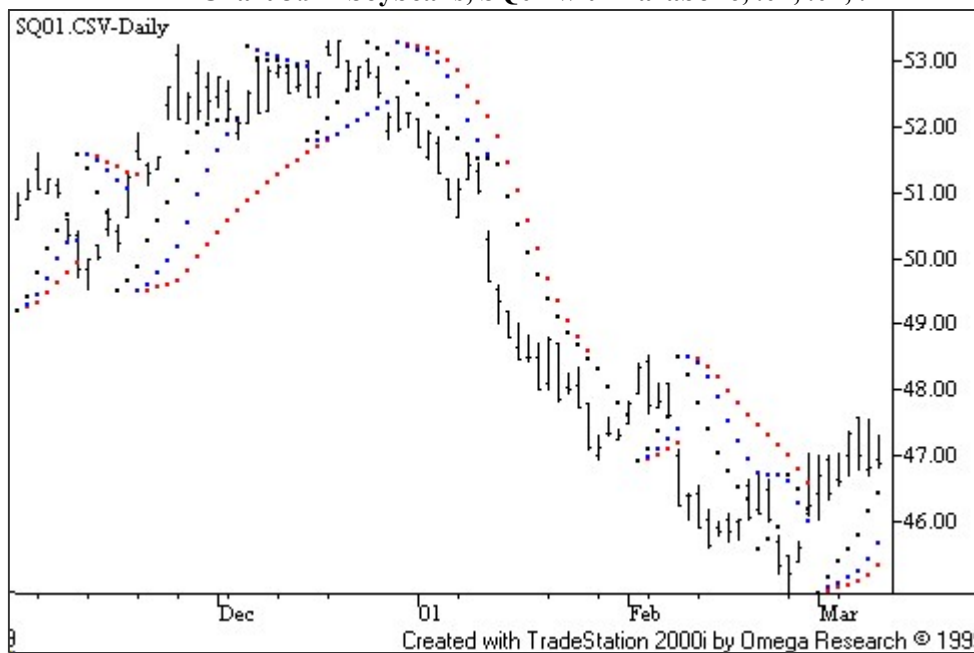
The acceleration factor is increased every day that the market moves in the direction of the trade otherwise it stays the same. Do not increase over a maximum value, usually 0.20.

If long, $S = S[1] + AF(H[1] - S[1])$,

If short, $S = S[1] - AF(S[1] - L[1])$,

where AF is the acceleration factor and S is the Stop Value

Chart 3.9 – Soybeans, SQ01 with Parabolic, .02, .04, .12



The reason that the indicators with the three diverse settings converge is that they hit the maximum allowable setting for AF.

Parabolic is on the “right track” in that it uses a range value (Stop relative to High or Low).

Chart 3.10 – Brent, QOJ01 with Parabolic, .02, .04, .12

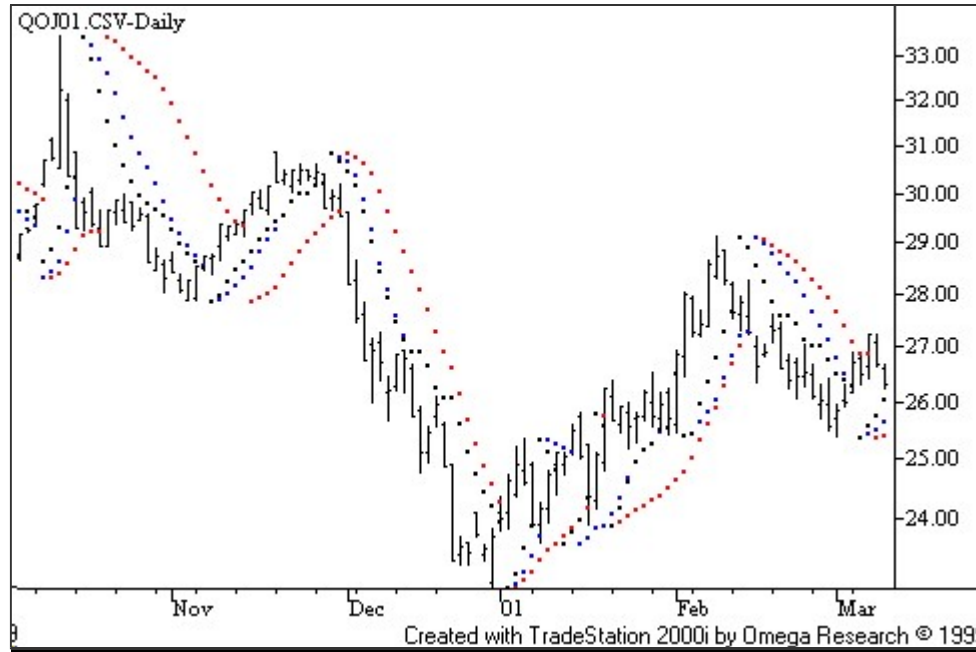
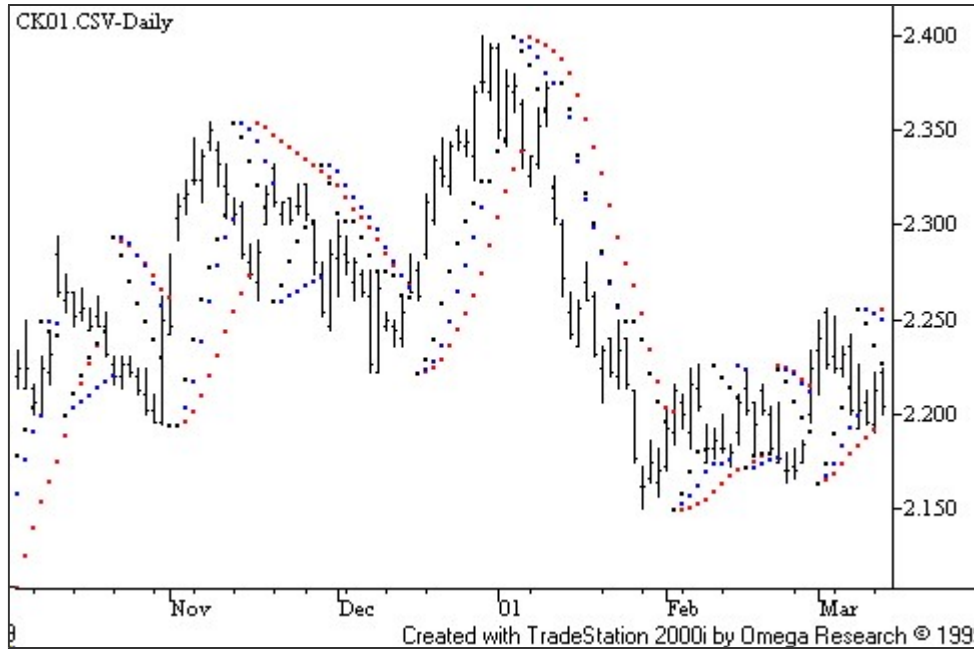


Chart 3.11 – Eurodollar, EDM01 with Parabolic, .02, .04, .12



Chart 3.12 - Corn with Parabolic, .02, .04, .12



Sidebar Probability, Volatility, and Some Math

Variance = Sum From 1 To N $((X1-Xm)^2 + (X2-Xm)^2 + (Xn-Xm)^2)/(N-1)$

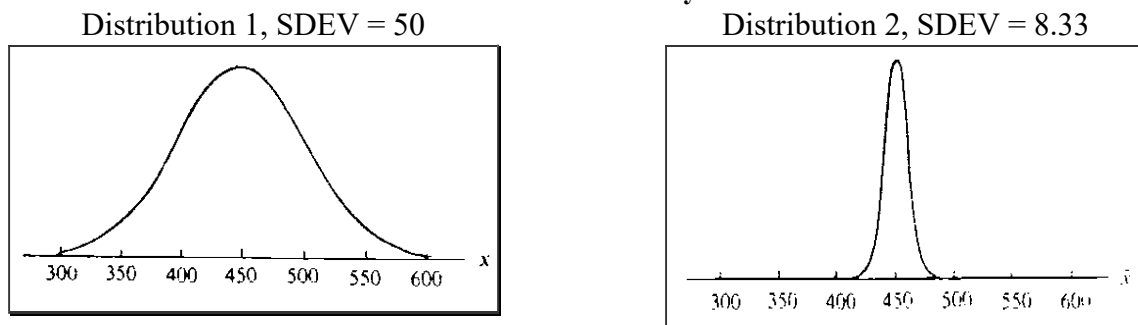
Standard Deviation = Square Root of Variance

Volatility is A Measure of Standard Deviation (σ)

Volatility = σ (Logarithmic Rate of Change of Price)

$$\text{Volatility} = \sigma \ln(P/P[1])_n$$

Chart 3.13 - Probability Distributions



The Wider the Distribution, the More Probable a Certain Price Will be Hit

Distribution 1 has a standard deviation of **50** points

Distribution 2 has a standard deviation of **8.33** points

The mean is 450 in both cases, and a 500 point move is equivalent to a ...

One standard deviation move for distribution 1, with about 15% odds

Six standard deviation move for distribution 2, with less than 0.1% odds

Normal Distributions Characterize Random Activity

Table 3.1 - Probabilities of The Standard Normal Distribution

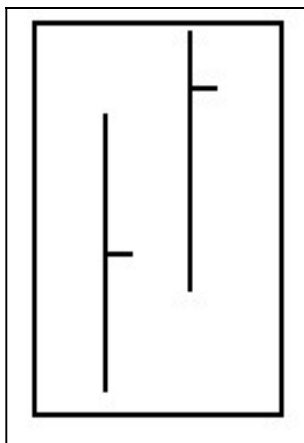
Cumulative Probability	No. Of Standard Deviations Above Mean
50	0.000
85	1.033
95	1.645
97.5	1.960
99.9	3.090
Around The Mean	No. Of Standard Deviations Around Mean
50	Zero
67	One
95	Two
99.7	Three

A Simple Way to Look at Volatility is True Range

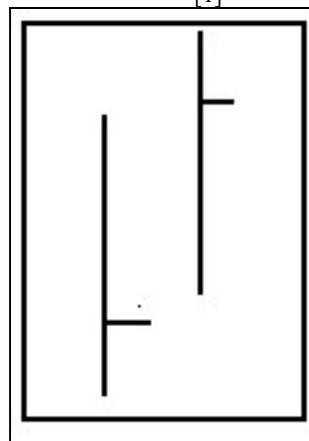
Maximum of:

1. $(H_t - L_t)$
2. Absolute $(H_t - C_{t-1})$
3. Absolute $(L_t - C_{t-1})$

$H - L$



$H - C_{[1]}$



$C_{[1]} - L$

